THE PROGRESS OF STATE INCOME TAXATION SINCE 1911

More than eight years have elapsed since the enactment of the Wisconsin income tax law, and it is perhaps worth while now to review the results of the new era of state income taxation which was then inaugurated. The earlier experiences of the American states with the income tax had been very unsatisfactory, for various reasons, and many students of the subject who had written before 1911 had condemned the income tax as a practical and effective source of state revenue.[1] In view of this earlier record there was no great enthusiasm, even in Wisconsin, for the new income tax.[2] But the success of this measure was so apparent, almost from the outset, that the income tax has experienced a sudden wave of popularity. The revenue possibilities of the federal income tax and the familiarity with income taxation which has accrued under the federal administration, have heightened this interest on the part of the states, many of which are in serious need of additional revenue resources. They are turning the more willingly and readily to a new fiscal source because of the restrictive constitutional provisions which in numerous states still cramp and confine the local revenue system within narrow limits. Constitutional amendments authorizing the income tax have been adopted in some states and proposed in others in which it has proved impossible to secure the removal or the relaxation of the rigid provisions of the uniform rule of property taxation.[3] It is the purpose of this paper to review very briefly the legislation thus far enacted, and then to undertake an appraisal of the progress which has been made since 1911. The legislative summary will be presented chronologically.

I

The Wisconsin income tax act, passed in 1911,[4] imposed a tax on all incomes, whether individual or corporate, earned or produced within the state. The situs of the source of the income

[1] *Cf.* Seligman, *The Income Tax* (1911), pp. 654-655; Kennan, *Income Taxation* (1910), pp. 318-325; Kinsman, *The Income Tax in the American Commonwealths,* esp. pp. 120-121.

[2] *Report of the Wisconsin State Tax Commission,* 1898, p. 168. Wisconsin Tax Commission, *Report,* 1909, p. 17.

[3] For example, in Indiana and Ohio.

[4] *Laws of Wisconsin,* 1911, ch. 658.

rather than the residence of the owner or receiver of the income was thus made the test of liability to the tax, which was levied on nonresidents and foreign corporations in respect of the income derived from sources within the state. This test made necessary a rule of allocation, whereby taxable income in the form of rents, royalties, and gain, or profit from the operation of any farm, mine, or quarry should follow the situs of the property from which derived; and income from personal service and from land contracts, mortgages, stocks, bonds, and securities should follow the residence of the recipient. Business incomes were to be apportioned to the state according to a statutory rule which was originally written for the purpose of determining the proportion of capital stock employed within the state.[5] The rates were made progressive, and separate schedules were provided for individual and corporate incomes. In the original act an effort was made to bolster up the assessment of corporate property by adjusting the rate of income tax to the relation of earnings to assessed valuation, but this complicated arrangement was in force only two years.[6] The personal property tax offset, introduced as a means of safeguarding the revenues while the income tax was in the experimental stage, remains in force, although the tax commission is now recommending its withdrawal.[7] A personal exemption of $800 was allowed to unmarried persons, and of $1200 to husband and wife, with $200 additional for each child under eighteen and for each additional person actually supported by and dependent upon the taxpayer. No exemption was allowed to corporations.

The next state income tax laws were passed in 1915, by Oklahoma, Connecticut, and West Virginia. The Oklahoma law imposed a tax upon the net income of "each and every person in this state," and upon the entire net income from all property owned, and of every business, trade, or profession carried on within the state by persons residing elsewhere.[8] No rule of apportionment to the state was provided in the act, the entire administration of which was left to the auditor of state. The rates were made mildly progressive and the receipts were to be used for general state purposes. The personal exemptions were placed at $3,000 for a single individual, with $1,000 additional for wife or husband,

[5] *Code of Wisconsin,* sec. 1770b, subsec. 7.

[6] Repealed by *Laws of Wisconsin,* 1913, ch. 720.

[7] Wisconsin Tax Commission, *Report,* 1918, pp. 6-8.

[8] *Laws of Oklahoma,* 1915, ch. 164.

if living with the taxpayer, and $300 for each child under eighteen years. Beyond these the taxpayer was to be allowed $500 for each child or other person for whose support he was legally liable and who was actually and permanently domiciled with him, while such dependent was engaged solely in acquiring an education, and $200 in other cases.

The laws of Connecticut and West Virginia are quite similar in purpose, since both apply only to corporate incomes derived from sources within the state and both are in the nature of privilege or franchise taxes.[9] The Connecticut act requires each corporation subject thereto (the miscellaneous business corporations) to file with the tax commissioner a copy of the return to the federal Internal Revenue Department, and the federal determination of net income is accepted by the state, with no provision for an independent audit or determination of net income by the state tax authorities. The West Virginia act requires the state tax commissioner to determine the net income and assess the tax, but the data to be reported are similar in general to those on the basis of which net income is computed under the federal law. In the case of concerns doing business in more than one state, the Connecticut law provides for an apportionment on the basis of gross receipts, if the income be derived principally from the holding or sale of intangibles, and on the basis of the relative fair cash value of the real and personal property with no allowance for incumbrances thereon, if the profits be derived principally from the holding or sale of real estate or tangible personal property. In West Virginia the income of corporations doing business in more than one state is to be apportioned to the state in the ratio that the assessed valuation for purposes of taxation of assets and property located within the state bears to the total assessed valuation of assets and property in the jurisdictions where located. The Connecticut rate is 2 per cent, the West Virginia rate ½ per cent, and in both instances the proceeds are for general state uses.

The Massachusetts law of 1916 applied to certain incomes only.[10] Income received by inhabitants of Massachusetts from such forms of intangibles as were taxable as property under the

[9] *Laws of Connecticut,* 1915, ch. 292; *Laws of West Virginia, Second Extraordinary Session,* 1915, ch. 3. In the latter state the tax was expressly declared to be a privilege tax, while in the former it was so construed by the court in *Underwood Typewriter Co.* v. *Chamberlin.*

[10] *Laws of Massachusetts,* 1916, ch. 269.

existing laws was taxed at 6 per cent, incomes derived from annuities, trades, and professions were taxed at 1 ½ per cent, and gains from dealings in intangibles were taxed at 3 per cent. If the total taxable income from interest and dividends did not exceed $600, and exemption of $300 was allowed, provided that in the case of married persons the exemption was not to be taken if the total income from all sources was in excess of $1200. If the total income from all sources did not exceed $600, annuities were exempted up to $300, but only one such exemption might be taken. An exemption of $2,000 was allowed in the case of business and professional incomes. The tax on intangibles was in lieu of the former property taxes upon these evidences of ownership. The administration of the tax was effectively centralized in the hands of the state tax commissioner, and the receipts, less the costs of administration, were to be distributed locally. The object of the permanent distribution scheme, which is to become finally effective after 1928, is to distribute the proceeds of the income tax in the same ratio as the state tax levy, after allowing for a ten-year period of gradually diminishing compensation to localities on account of the loss of revenue from intangibles returned for taxation.[11]

The year 1917 saw four other states added to the list of those which sought financial relief through the income tax. These states were New York, Montana, Missouri, and Delaware. The New York and Montana acts applied to corporations only; the Missouri law included the entire income of residents and such incomes of nonresidents and of corporations as were derived from intrastate sources; and the Delaware law applied only to the incomes of resident individuals.

The New York income tax law of 1917 applied to the miscellaneous mercantile and manufacturing corporations and replaced the older franchise tax on the capital stock of such companies, although such a basis was retained for the determination of a minimum in case a corporation had earned no net income.[12] A flat rate of 3 per cent, advanced in 1919 to 4 ½ per cent, was levied, and an elaborate rule was provided for the apportionment of net income to the state. The substitution of this tax for the local taxes on corporate personal property necessitated a reimbursement of localities for the loss in revenue. One third of the yield was set

[11] *Cf. Report of the Joint Special Committee on Taxation,* 1919, pp. 46-49.
[12] *Laws of New York,* 1917, ch. 726.

aside for this purpose, to be distributed locally in the proportion that the tangible personal property of such corporations in each district bore to their total property within the state. Administration was placed with the state tax commission.

The Missouri income tax follows fairly closely the federal act of 1916 in its definitions of gross income and in the deductions allowed both to individuals and corporations for the determination of taxable net income, with the omission of the allowance to individuals on account of philanthropic contributions.[13] The undistributed profits section of the federal law[14] was also copied; and the state auditor, who is in general charge of the administration of the tax, is given discretionary power to certify whether or not any given accumulation of earnings is unreasonable for the needs of the business. A credit is allowed on account of dividends paid by companies which are subject to the act. This deduction appears to be so worded as to allow exemption of the total dividend paid by corporations subject to the act, although only that part of their net income which originates within the state is taxable.[15] The personal exemptions follow those of the federal law, but are not allowed to nonresidents.

The rule for the apportionment of corporate income to the state rests on the business done within the state, by which is evidently meant the volume of sales within the state, increased or decreased by the gain or loss shown by the inventories of finished and unfinished products, raw materials, etc., at the beginning and the end of the year. The deduction on account of corporate indebtedness is limited to that proportion of the sum of the entire amount of paid-up capital stock and one half of the outstanding indebtedness which the gross income within the state bears to total gross income. All taxes except special assessments, by whatever authority levied, are deductible. A flat rate of 1 ½ per cent is levied on both individual and corporate incomes and the yield goes apparently to the state treasury.

The Montana income tax law follows closely the provisions of the Missouri law relating to this subject, except that a flat exemption of $10,000, reduced to $2,500 in 1919, is allowed to each

[13] *Laws of Missouri,* 1917, p. 524.

[14] *Income Tax Act of September 8, 1916,* sec. 3.

[15] *Cf.* section 6, paragraph 9 of the law and page 21 of the Income Tax Regulations.

corporation liable under the act.[16] The rule for the apportionment of income to the state differs from that in the Missouri law as does that for the deduction of interest and taxes. In Montana the taxable net income of corporations engaged in both intrastate and interstate business is to be determined by deducting from the intrastate gross earnings such proportion thereof as the total expenses for maintenance and operation, within and without the state, bear to the total gross receipts from all sources. Interest and taxes are deductible in the same proportion that intrastate gross earnings bear to total gross earnings. The state treasurer is in charge of the law, subject in certain respects to the approval and supervision of the state board of equalization. The rate is 1 per cent and the revenue is to be used for state purposes.

The original Delaware act exempted income derived from agricultural operations; but this unusual and, we may add, unwarranted exemption was withdrawn in 1919.[17] The determination of income under the present law is substantially the same as under the federal law, except for the necessary exemption of federal agencies *in toto,* and the omission of the exemption to philanthropic contributions. The state treasurer is in charge of the act, with power to appoint a deputy clerk who shall actively supervise its operation. Two special collectors of state revenue were provided in 1919, to assist in seeking information at the source, investigating returns made by individuals, and in other ways checking results obtained under the original assets. A flat rate of 1 per cent is levied and the proceeds go into the state treasury. One thousand dollars of income is exempted to each taxable.

In 1919 three new states, New Mexico, North Dakota, and Alabama, entered the income tax field, and the legislatures of Minnesota and Indiana voted to submit constitutional amendments which would permit the use of the income tax. New York introduced a personal income tax and the Massachusetts corporation tax was modified to include an excise tax based in part on such net income of domestic and foreign corporations as was derived from business done within the commonwealth.

The New Mexico law applies to all natural persons and to all firms, corporations, joint stock companies, and associations hav-

[16] *Laws of Montana,* 1917, ch. 79; *ibid.,* 1919, ch. 69.

[17] *Laws of Delaware,* 1917, ch. 26; *ibid.,* 1917, ch. 30.

ing a place of business within the state, and to all persons, firms, etc., owning or operating oil or gas wells.[18] The administrative provisions are not clear and are certainly weak. The state treasurer receives all returns from taxpayers and collects the taxes, but the assessment of the tax is apparently to be made in the several counties.[19] The rate is graduated from ½ per cent on incomes of $5,000-$10,000 to 3 per cent on the amounts in excess of $50,000. A personal exemption is allowed of $1,000 to single persons and $2,000 to heads of families, with $200 additional for each dependent. The rate on incomes up to $5,000 is not clear. The revenue is to be used for the support and maintenance of various state institutions.

The North Dakota income tax act contains a number of provisions which are not found in other state income tax acts, but the distinction thereby achieved is not entirely enviable.[20] These peculiarities are in part, doubtless, the result of the desire to give expression to the social philosophy which underlies the present experiment in government in North Dakota. The most important point of contrast is the distinction between "earned" and "unearned" incomes. It is always difficult to apply this distinction logically and consistently to some forms of income on the borderline, and the North Dakota legislature did not escape all of the pitfalls. Earned incomes are defined to include any income received as wages, salary, or fees for personal service, or the profits from any business personally managed or conducted as an individual business or partnership, but not including the business of corporations, joint stock companies, or associations. Unearned income includes rents, royalties, interest on mortgages, notes, and bonds; also dividends on shares of stock or other interest in industry not personally conducted by the taxpayer; and from any other source whatever excepting the skill, labor, or personally conducted business or industrial enterprise of the person receiving the income. The penalty upon the corporate form is evident. A group of men receive earned income as partners, but the same group, managing the enterprise in the same manner, receive unearned income as stockholders. Income from loans on North Dakota real property is entirely exempted from the tax, although

[18] *Laws of New Mexico,* 1919, ch. 123.
[19] *Cf.* sections 3 and 4 of the act.
[20] *Laws of North Dakota,* 1919, ch. 224.

such income would clearly be "unearned" within the definition of this term. The distinction between earned and unearned incomes has just been eliminated from the law.[21] The personal exemptions are similar to those in the federal law.

The rates applying to the two classes of income are elaborately and, in the writer's judgment, uselessly graduated. Differences in ability to pay, whether indicated by amounts of income or by the "earned" or "unearned" character of the income, cannot be measured with the minute accuracy that is here implied. The rates rise steadily for both classes of income, and the total tax burden on given amounts of the two classes of income presents the singular phenomenon of a heavier rate of increase on the earned incomes than on the unearned, as shown below:

Amount of income	Total taxes on Earned incomes	Total taxes on Unearned incomes
First $10,000	$137.50	$275.00
Second $10,000	387.50	600.00
Increase	$250.00	$325.00
Per cent of increase	181.18 per cent	118.18 per cent

The increase of taxes for the third $10,000 of earned income over the taxes on the second $10,000 is $212.50, or 54.8 per cent, while for the same amount of unearned income it is $200, or 33 1/3 per cent. This discrepancy was hardly intended and was produced by introducing, after $10,000, much larger income brackets for unearned income, while the minute graduation of rate for earned incomes was continued through $20,000 of income.

Greater emphasis is placed upon collection at the source in North Dakota's law than in any other state income tax law, notwithstanding the unfortunate experiences under the federal income tax.[22] This system of collection must involve tremendous administrative difficulties and complications, for the withholding agents are required to deduct from each payment of interest, dividends, or other form of taxable income, such part as will be required to pay the tax, and there are no less than twenty-three different rates any one of which may be the proper one in a given case. The taxpayer may procure a deduction or allowance by

[21] *Bull. Nat. Tax Assoc.*, vol. V (Jan., 1920), p. 101.

[22] *Cf.* National Tax Association, *Proceedings of the Ninth Annual Conference,* 1915, esp. pp. 284-290.

filing with the tax commissioner a statement of total net income and of the separate items for which the deduction or allowance is claimed. All collection agencies are required to obtain a license from the tax commissioner, under penalty of $5,000 fine or one year imprisonment or both.

Two taxes are provided for corporations. The first is a flat tax of 3 per cent on total net income derived from sources within the state, and the second is a tax of 5 per cent on the amount of income remaining undistributed six months after the end of each calendar year. A credit is allowed, in applying the first of these, of all dividends received from corporations also subject to the 3 per cent tax, but such dividends must of course be included in the return of undistributed net income for the purposes of the 5 per cent tax. The latter does not apply to income retained for use in the business, but if the tax commissioner finds that income so retained is not employed in the business, or is not reasonably required by the business, it is to be taxed at 10 per cent. If a concern is engaged in business within and without the state, net income is to be apportioned on the basis of the business done, and in the event that this is not more readily ascertainable, business done within the state shall be that proportion of the total which the property within the state bears to the total property of the concern. The property of public utilities is to be allocated to the state on the mileage basis.

The assessment of all corporate income is to be made by the state tax commissioner, who is given the usual powers of prescribing the form of returns to be made, compelling the production of books and papers and the appearance of witnesses, and authorizing adaptation to the fiscal year. The assessment of individual incomes is to be made by income tax assessors appointed by the tax commissioner, and working in districts determined by him. The receipts are to be used for general state purposes.

The New York income tax law of 1919 applies to the entire income of residents and to the income of nonresidents in so far as the latter is earned or produced within the state.[23] The decision of the lower federal court in the Yale and Towne case will not prevent an assessment of the income of nonresidents. This New York act follows very closely the federal law in the determination of gross and net taxable income and in the exemptions allowed.

[23] *Laws of New York,* 1919, ch. 627.

The state comptroller rather than the tax commission was given administrative charge, for political reasons. The rates were made moderately progressive, rising from 1 per cent on the first $10,000 of taxable income to 3 per cent on all income above $50,000. One half of the yield is to be distributed locally in accordance with a rather complicated scheme worked out by the state tax commission, and the remainder goes to the state.

The Massachusetts income tax on corporations was enacted in connection with certain changes which were being made in the corporation tax.[24] The new tax consists of $5 on each $1,000 of corporate excess, and a rate of 2 ½ per cent on that part of the net income which is derived from business carried on within the commonwealth. Except for affiliated companies, making a joint federal return, which are to file with the tax commissioner a return in accordance with the law and the regulations governing the usual federal return, the term "net income" is defined to be the net income for the taxable year as reported to the federal government. Deduction is allowed for all interest on obligations of the United States, all dividends received from domestic corporations and all other dividends which would be exempt if received by an inhabitant of the commonwealth. Apportionment of income to the state is made by a new and very suggestive method which is described below.[25] One sixth of the entire tax is to be paid to the state; the remainder is to be distributed locally to the districts in which the corporation does business, on the basis of the relative amounts of tangible property of the corporation. If it conducts no business in Massachusetts the entire tax is paid to the state.

The Alabama income tax law of 1919 has not been available to the writer, and no reference can therefore be made to its provisions.

II

This extremely condensed summary of the large grist of state income tax laws already produced shows that the usual tendencies in state tax legislation are at work—great diversity of form, absence of standards, and the presence of double taxation. It is too early, perhaps, to prescribe the ultimate form which such a

[24] *Laws of Massachusetts*, 1919, ch. 355. *Cf. Report of the Joint Special Committee on Corporation Tax*, 1918. Also, *Report of the Joint Special Committee on Taxation*, 1919, part I.

[25] *Cf.* below, p. 88.

tax should take, or to predict the ultimate degree of usefulness which it will prove to possess as a source of state and local revenues. Some questions of form appear to be fairly well settled, as the result of federal and state experience, while others are more debatable. Varying local conditions will always prevent absolute uniformity in state tax legislation, as they will always justify certain distinct local types, such as the Massachusetts tax on personal incomes. Fundamental differences in economic conditions in different sections will doubtless perpetuate a certain conflict of local interests which will find expression in the formulation of legislation best designed to serve the local interest, regardless of the best general results. The ensuing comments and suggestions are offered in no dogmatic spirit but in the hope that they may contribute to the increased effectiveness of the income tax in all sections, and, so far as this is possible, to the greater uniformity of income tax legislation and administrative procedure.

The first question that naturally arises in any discussion of comparative standards in income tax legislation is that of the proper definition of gross income and the proper deductions to be allowed in the determination of taxable net income. The greatest progress in formulating and clarifying these concepts has been made in the federal income tax legislation of the past six years, and we are now fairly clear as to the proper content of the concepts of gross and net income. The federal concepts are in general acceptable and might very well be followed, with some modifications to be suggested below. Indeed, there would be certain obvious advantages in following the federal terminology and practice because of the universal familiarity of taxpayers with the federal usage. The principal changes which the writer would suggest in the federal definition of gross and net income as these are carried over into the state income tax laws are the following.

The first change would be a more definite requirement for the return of total income from all sources, whether taxable or not. Section 213 of the federal act of 1918 appears to undertake two things and the result is failure to make a proper distinction between items which should not be included in gross income, because they are not income at all, and items which are properly income but of a sort which it is intended to exempt. In the former class would be found such items as the proceeds of life insurance policies, the value of property acquired by gift or bequest, and

amounts received under workmen's compensation acts; and in the latter class would be interest on exempt bonds and income received for military and naval service. A proviso in section 213 does require a statement of exempted bonds, but the inclusion of the interest therefrom in total income should be more clear and specific because of the bearing upon the interest deduction, to be discussed below.[26]

A second proposed change relates to the method of dealing with gains from the sale or other disposition of capital assets. There is doubt in some quarters as to the wisdom of treating such gains as taxable income at all, and with this view the writer has some sympathy, because it appears, under even the most favorable construction, that such a tax operates as a bar or hindrance to the ready transfer of property. Moreover, it results in imposing a burden on the person who sells which is escaped by the one who does not sell.[27] On the other hand, without some such provision it might be difficult to reach the gains or income of the professional trader or dealer in land, or durable capital or consumer's goods; and it is, of course, impracticable to attempt either a statutory or administrative distinction between the professional trader and the casual operator. The dilemma is a serious one, and, all things considered, it may be wiser from the practical standpoint to impose the tax. In this event some limit should be set to the amount of the increase in capital value which is to be subject to the tax. The successive federal acts have retained March 1, 1913, as the date for the determination of the basic value of property acquired theretofore, and in the event of sale or other disposition they have required the inclusion in gross income of the whole gain accruing since that time. A seven-year interval has already elapsed and there is no apparent disposition to move the basic date forward; meantime, as values advance, every owner of property, and especially of real estate, finds himself less disposed to effect a sale or

26 *Cf.* below, p. 79.

27 According to the distinction set up by Professor Seligman in his recent paper, "Are Stock Dividends Income," American Economic Review, vol. IX (Sept., 1919), p. 517, the man who sells has realized his gain, hence it is income; but the unrealized gain of another man who owns the same kind of property, say a farm, but who does not sell it, is an accretion to capital, hence not income. It is impossible to convince the average farmer or business man of the soundness of this distinction or, at least, of its wisdom in a tax law, when the practical effect is to penalize so heavily the man who sells his property.

transfer because of the increasing tax burden due to the graduation of tax rates. This will mean that land and capital goods will in many cases be retained by those whose use of them is less efficient, and the entire community will be penalized by this check upon alienation. The taxing agency should consider these indirect effects and content itself with a moderate compromise, an example of which was contained in the proposed Ohio income tax law.[28]

This compromise limited the gain to be taxed to that which had accrued during the three years preceding the date of sale or transfer, but in no event prior to the year to the income of which the tax first applied. The basic value for the measurement of taxable gain from the sale or transfer of capital assets would then be either the cost of acquisition or the value as of a date three years prior to the date of sale. Further, the gain was presumed to have accrued uniformly over the three years and was to be taxed at the rates in effect during these years; and, finally, the taxpayer was given an option of paying the tax in the year of sale, as outlined above, or of reporting annually the increase in value as disclosed by an inventory and paying the tax in each year, whether in anticipation of a sale or not. In such case permission was also to be given to deduct losses disclosed by the inventory as an offset to the gains reported in other years.

The proper treatment of stock dividends is another moot point. The economic question involved is whether such dividends are really income: the weight of the authority, and of the reasoning, is on the negative.[29] Nevertheless, the federal laws since 1916 have contained the provision for the inclusion of stock dividends in gross income, and the state laws without exception have followed the example. The constitutional aspects of the question are still before the Supreme Court on the second hearing and it is useless to speculate on the legal points involved. The issue in the case before the court, as the writer understands it, however, is not at all the economic question as to whether stock dividends are income. The generally accepted view is that the stock dividend is,

[28] This bill failed of passage. It is found in the appendix to the *Report of the Joint Special Taxation Committee of the Ohio 83rd General Assembly,* 1919, pp. 147 ff.

[29] *Cf.* Seligman, *loc. cit.*; also, Fairchild, "The Economic Nature of the Stock Dividend," *Bull. Nat. Tax Assoc.,* vol. III (Apr., 1918), p. 161; and *ibid.,* "The Stock Dividend, A Rejoinder," *op. cit.,* p. 240.

as Professor Davenport has put it, "a mere reshuffling of titles";[30] and it follows, regardless of the court's decision, that they should not be included in the return of gross income.

A third point at which all income tax laws, both state and federal, need improvement is in the means for avoiding the discrimination which, while not authorized by the language of any of these laws, is in practice permitted. This discrimination operates against all who live in cities and buy their means of subsistence, and in favor of farmers and rural dwellers whose subsistence is incidentally produced in the larger farm operations. It is universal, in income tax laws, not to permit the deduction of living or family expenses, but such deduction is in practice taken by the large majority of farmers. The administrative difficulties involved in securing a proper return of that portion of the farmer's income which is consumed rather than sold or converted into cash are tremendous, and these difficulties are enhanced by the well known shortcomings of farmers' accounting methods. It is hardly surprising that farmers and rural dwellers generally disregard the value of products consumed in making a return, or in considering whether they should make a return at all. An effective state administrative organization, with income tax assessors who could come into fairly close contact with the rural population, would undoubtedly have a better chance at securing proper return of such income than the federal authorities have. Such administrative efforts would have a much greater probability of success if the law under which they were made contained very definite provisions relating to income of this sort; and every state income tax law should contain such provisions.

It is true that in the somewhat similar matter of house rents, the Wisconsin tax commission found that the game was not worth the candle. The Wisconsin law of 1911 required the inclusion, as income, of the estimated rental value of premises occupied by the owner, against which, as deductions, he was to be allowed the expenditures for maintenance and repairs. The efforts involved in a proper estimate of rental value and the proper accounting for deductible outlays was so disproportionate to the result that this provision was repealed in 1917.[31] The two cases are not exactly

30 Davenport, "The Stock Dividend Again," *Bull. Nat. Tax Assoc.*, vol. IV (Nov., 1918), p. 58.

31 *Laws of Wisconsin*, 1917, ch. 374; also, Wisconsin Tax Commission, *Report*, 1916, pp. 46-47.

parallel, for, in the case of produce consumed on the farm, no separate deductions as expense would be necessary. When the farmer does make a return he deducts the entire expense of farm operation, so that no separate accounting for the cost of producing that portion of the product consumed is involved. Furthermore, the net advantage would be greater in the latter case, by the difference between the average rental value of dwellings and the average value of products consumed by the typical rural family. This game would certainly be worth the candle in those states in which the agricultural element is significant.

On the side of deductions the most important change from the present provisions of the federal law should be a restriction of the amount of interest on indebtedness which should be deductible. The proper standard for such a deduction is suggested by the *Report on a Plan for a Model System of State and Local Taxation.*[32] This is that the proportion of interest on debts be allowed which the income from taxable sources bears to the total income from all sources. The section covering this point in the original draft of the New York personal income tax law is worthy of a place in every state income tax act. The deduction of interest is to be: "The same proportion of interest paid or accrued within the year on indebtedness which the amount of such gross income as herein defined (*i.e.*, gross income from taxable sources) bears to the gross amount of the income from all sources within and without the state."

The deduction of all taxes, except special assessments, by whatever authority levied, is allowed to individuals by all of the state laws except that of New York, which expressly excludes deduction of income taxes imposed by the United States or by any other state or taxing subdivision. Eminent legal authorities appear to differ on the question of the right to deduct federal excess profits taxes under the New York law applying to business corporations.[33] In all other states this deduction is permitted, although in Montana the amount of taxes to be deducted depends on the relative

[32] Reference is made to the *Preliminary Report of the Committee Appointed by the National Tax Association to Prepare a Plan for a Model System of State and Local Taxation,* p. 15. Cited hereafter as in the text above.

[33] *Cf.* Powell, "Should the Excess Profits Tax be Deducted in Computing the New York Franchise Tax on Mercantile and Manufacturing Corporations," *Bull. Nat. Tax Assoc.,* vol. IV (Dec., 1918), p. 66, and Zoller, "Taxable Net Income under the New York Law," *ibid.* (Jan., 1919), p. 97.

intrastate gross earnings of the business. It is probably best to allow such deductions *in toto*, since it is hardly equitable to levy on either an individual or a business concern because of taxes paid in another jurisdiction.

Another fairly well established feature of income taxation is the type of administrative control required. The most significant contribution which Wisconsin has made to the modern income tax movement has been the development of an efficient administrative organization and the demonstration of the value of such an organization for the success of the tax. In almost every state in which it is worth while to attempt an income tax, special administrative machinery will be required. The existing state and local officials are already burdened with other duties and the income tax must compete with these other and often varied obligations for attention. The tax commission or the tax commissioner is the logical head of the income tax administration, and this head must have ample and effective control over the officials actively concerned with the assessment of incomes. The assessors of incomes are preferably to be centrally appointed, but they should enjoy such tenure and dignity of office as will enable them to establish and maintain those local contacts which are as valuable in securing results as they are in toning down the harshness which otherwise might enter an administration entirely removed from local control and influence. The necessarily inquisitorial character of income tax administration must and can be tempered by the establishment of a relationship of goodwill and mutual respect between assessor and taxpayer.

The further details of the administrative organization are capable of some modification to meet local conditions, provided effective central control is maintained. The more satisfactory plan is that followed in Wisconsin, New York, Massachusetts, and some other states, of providing for income tax districts and an appointive assessor of incomes in each district.

Other administrative matters which deserve mention are the procedure of actual assessment and of appeals, and the system of collection. On the first two of these points the writer ventures to quote some paragraphs from a *Report on the Operation of State Income Taxes*, written for the Ohio Joint Taxation Committee.[34]

[34] "Report on the Operation of State Income Taxes," by H. L. Lutz, in *Report of the Joint Special Taxation Committee of the Ohio 83rd General Assembly*, Appendix, esp. pp. 94-95.

For the actual calculation and assessment of the amount of income tax due, there have been developed, in general, two methods. One method, which is illustrated in the federal practice, is to require the taxpayer to calculate the tax due and remit all or a part of it with the return. After an audit, which is supposed to be made promptly but which may not occur until a lapse of one or more years, the correctness of the return and the payment is finally determined. The other method, which is found in Massachusetts, is the calculation of the tax due by the administrative officials. Returns are due by March 1, the assessment or determination of the tax due is made in the office of the income tax deputy and tax bills are mailed, by September 1, and the tax is payable by October 1. This plan has the merit of a prompt determination of the tax due, although it is open to the objection of hasty auditing, additional clerical and postage expense, and possible inaccuracy due to crowded work. On the other hand it may lift a part of the burden of preparing the tax return from the taxpayer. Certain deductions allowed from the interest and dividends taxable under section 2 are permitted by section 3, and the calculation involved in this deduction is almost necessarily performed by the tax officials, since the method of determining the deduction provided by the section is almost certainly incomprehensible to the average taxpayer.

A necessary part of the administrative machinery of every tax act is the procedure for review and abatement of assessments. This is always a difficult problem, for neither of the practicable alternatives is wholly satisfactory. In general, the tax assessing and administrative officials may be designated as a reviewing board, whose findings on the facts may be final; or an appeal may lie to some outside authority, usually a court, which is often lacking in the technical qualifications required for passing upon disputed issues of fact. All things considered the review upon the facts should be conducted by the higher taxing authorities, with proper safeguards for the protection of all legal rights by the courts.

A third variation in systems of collection is found in Wisconsin; and, especially for the state income tax, this plan appears to possess decided advantages. The income taxes assessed are certified to the local collectors of property taxes and are entered, on a separate tax roll or duplicate, for collection at the same time and in the same manner as other taxes. The low personal exemptions which should be allowed in a state income tax mean that a large number of persons will become liable for income tax who do not ordinarily have a bank account. These persons will be obliged, otherwise, to remit to the state by means of money-order, draft, or in cash. There will be additional expense and inconvenience to these taxpayers, and a possibility of some loss if cash is sent.

Payment to the local collectors avoids what might become a source of friction and complaint against the law.

Another point which is fairly well settled in principle, if not in practice, is the relation of income and property taxes. This relation is acceptably set forth in the *Report on a Plan for a Model System of State and Local Taxation.* Three separate taxes are there proposed: a personal income tax, a classified property tax, and a business tax. Such a combination, it is asserted, will satisfy every legitimate claim of any American state. Its substance is thus summarized in the language of the report:[35]

> It provides that all persons should be taxed fairly and fully at their place of domicile for the personal benefits they derive from the government. It provides that all tangible property which any state may desire to tax shall be taxed fully at its situs for the governmental services it there receives. It eliminates the taxation of intangible property, as property, because such taxation cannot be carried out without a large amount of unjust double taxation. And, finally, it provides a method by which any state which desires to tax business may do so in a fair and effective manner.

A number of the states have made encouraging progress toward the proper correlation of income and property taxes. Wisconsin, New York, and Massachusetts have exempted intangibles entirely from taxation as property, and in the first-named state the exemption was extended also to some of the more troublesome forms of tangibles. At the same time the familiar device of the personal property tax offset was introduced, whereby any taxpayer might present his personal property tax receipts toward the payment of his income tax. North Dakota, New Mexico, and Missouri have permitted the offset of all taxes on personalty, and in the original Missouri law the deduction of all property taxes was permitted. This costly blunder was corrected in 1919 and the offending section was characterized as being "confusing and misleading, and in practical results destructive of the ends sought by the act."[36] In Ohio, where efforts are at present being made to secure an income tax, the curious spectacle was recently presented of certain interests vigorously opposing a classification amendment and at the same time advocating an income tax, with a personal prop-

[35] *Op. cit.*, p. 33. *Cf.* Seligman, "The Taxation of Nonresidents in the New York Income Tax Law," *Bull. Nat. Tax Assoc.*, vol. V (Nov., 1919), p. 40.

[36] *Laws of Missouri*, 1917, p. 524; *ibid.*, 1919, p. 718.

erty tax offset, "like that of Wisconsin."[37] As a matter of fact, not only in Ohio but in western states which have the personal property tax offset, the real point of such a device is missed.

The real purpose of such an offset, in Wisconsin, was that of safeguarding state and local revenues during the initial period of uncertainty as to the yield of the income tax, its constitutionality, and its permanence in the state tax system.[38] A somewhat similar expedient was employed in 1900 at the time of the transition from the gross earnings to the ad valorem basis of railroad taxation.[39] The tax offset has served its purpose as a temporary and emergency measure and the tax commission now urges its withdrawal. There is certainly very little to be said for a permanent offset of the taxes on tangible personalty against the income tax. The double taxation argument, if sound, would apply with quite as much force to real estate, the owner of which has quite as good a claim to an offset as does the owner of tangible personalty. The treatment of intangibles as property does involve double taxation and the laws of the progressive states contain recognition of this fact. It cannot be plausibly argued that a tax on property and another tax on the income from the property is improper double taxation, for we are here dealing with two different objects of taxation. Objectionable double taxation does appear to have been introduced by the North Dakota law, in requiring the taxation of dividends as unearned income and at the same time permitting no credit or offset to the individual on account of the taxes paid by the corporations subject to the act.

Another point at which it is very necessary to have uniformity of practice is in the treatment of nonresidents. This uniformity is attainable in either of two ways: the application of the tax to residents only, as in Massachusetts, or the extension to nonresidents of a credit on account of income taxes paid in the state of residence, as in New York. All of the western states tax nonresidents, but none of them allow such credits, although the Oklahoma law apparently permits the personal exemption to nonresidents and the North Dakota law authorizes it on application. A partial

37 The classification amendment was defeated in November, 1918, by about 77,000 votes, largely through the activities of the Ohio Grange, which thus put itself in the position of defender and advocate of the general property tax. *Cf. Bull. Nat. Tax Assoc.*, vol. V, p. 65.

38 Wisconsin Tax Commission, *Report*, 1918, p. 7.

39 Lutz, *The State Tax Commission*, p. 258.

justification for the Wisconsin practice may be found in the different rule which governs the liability of all incomes to taxation in that state, but this principle is out of line with the modern tendency and should be changed.[40] There is little enough prospect of uniformity here, for we have to deal with another instance of fundamental conflict of interests between the western and the eastern states.[41] The logic of the situation would lead to the tax on residents only, as this would be the effect of the credit feature with the income tax in general use; but expediency calls for the other solution, since there would not be double taxation of the income of any given nonresident until the state of his residence also introduced such a tax.[42]

Finally, the fiscal adequacy and elasticity of the state income tax, under proper conditions, may be accepted as fairly well established. These conditions may be inferred from the experience of the two states whose financial results with the income tax have been most extensive. For Wisconsin the gain from the use of the income tax is shown in the following table:[43]

EXCESS OF INCOME TAX OVER THE PERSONAL PROPERTY TAX USED AS OFFSET AND THE ESTIMATED AMOUNT LOST BY THE EXEMPTION OF CERTAIN PERSONAL PROPERTY

Year	Income tax assessed	Personal tax used as offset	Estimated tax on exemptions	Delinquent income tax
1912	$3,482,000	$1,609,000	$700,000	$241,000
1913	4,084,000	1,805,000	700,000	251,000
1914	4,145,000	1,987,000	700,000	251,000
1915	3,837,000	1,825,000	700,000	105,000
Totals	$15,549,000	$7,228,000	$2,800,000	$753,000

Total income tax assessed	$15,549,000	Personal tax offset	$7,228,000
Total personal and delinquent	10,782,000	Estimated tax on exemptions	2,800,000
		Delinquent	753,000
Total excess	$4,767,000		
Average excess	1,191,000	Total	$10,782,000

In commenting on this table the tax commission states that a large

40 Wisconsin Tax Commission, *Report,* 1918, pp. 7-8.

41 For example, the inheritance tax. *Cf.* the discussion of the inheritance tax in the *Proceedings of the Sixth National Tax Conference,* 1912, pp. 303-320.

42 Professor Seligman has attempted to reconcile justice and expediency in his defense of the New York tax on nonresidents in the *Bulletin of the National Tax Association,* vol. V (Nov., 1919), p. 40.

part of the amount shown here as delinquent was really collected later by the county treasurers; and, in consequence, the excess of the income tax should be greater than is actually shown. From the published statistics for later years some of these totals may be extended:[44]

	1916	1917
Total tax assessed	$5,328,000	$9,482,000
Offset	2,211,000	3,307,000
Excess of income tax....	$3,118,000	$6,175,000

The total tax assessed for 1918 was $11,830,000. It appears from these figures that the yield of the income tax has expanded much more rapidly than the personal property tax offsets, and that there is, therefore, much greater elasticity in the former than in the latter tax.

The Massachusetts tax commissioner has published an exhibit of the assessments of the first year (see page 87).[45]

The amount of intangibles assessed in 1916 and the tax derived therefrom are not ascertainable since the Massachusetts tax returns did not separate the two classes of personalty. It required $8,120,621 to reimburse the cities and towns in 1917 for the loss of taxes due to the decrease in the total personalty assessed in 1917 below the amount assessed in 1915. This decrease represents the amount of tax which, it is assumed, had been derived from intangibles plus a small allowance for fuller disclosure of tangible property in 1917. Estimating the loss due to the $300 exemption and that due to the exemption of nonresident beneficiaries of estates and trusts at $2,100,000, the former yield of that part of the intangibles which paid income tax in 1917 was placed between $6,367,000 and $6,867,000.[46] The new tax represented, therefore, a real gain of about $2,000,000 in the first year. The total assessment of income for 1918, at the date of the annual report, was $14,387,000. It is quite evident, therefore, that the income tax on interest and dividends is proving to be very much more productive of revenue than the former taxes at high rates on the capital value of such intangibles as were listed.

43 Wisconsin Tax Commission, *Report,* 1916, p. 68.

44 *Ibid.,* 1918, p. 12.

45 Massachusetts Tax Commissioner, *Report,* 1917, p. 20.

46 *Cf.* the discussion in the *Report,* 1917, pp. 16-18.

Classification of Assessments Under the Income Tax, 1917

	Number of returns	Business income	Three per cent gains	Annuities	Interest and dividends	Exemptions, 6 per cent	Total
Individual	162,217	$1,625,905.71	$608,117.61	$24,111.51	$6,435,198.24	$103,219.20	$8,693,333.07
Partnership	10,071	923,867.82	176,080.59	———	452,972.82	6,968.04	1,552,921.23
Fiduciary.........	13,895	12,288.03	50,536.31	———	1,348,628.75	5,243.91	1,411,453.09
Total	186,183	$2,562,061.56	$834,734.51	$24,111.51	$8,236,799.81	$115,431.15	$11,657,707.39
Balance estimated (not in statistics)	5,000	15,000.00	1,500.00	100.00	460,703.70	5,000.00	477,303.70
Totals	191,183	$2,577,061.56	$836,234.51	$24,211.51	$8,697,503.51	$120,431.15	$12,135,011.09

The elasticity of the tax is a strong point in its favor, and practical benefits from this feature have already been realized by Massachusetts and West Virginia, through the readjustment of rates. In order to meet the unusual expenses of the war period Massachusetts levied an additional tax equal to 10 per cent of the taxes already laid on incomes.[47] This act was to be in force for one year only. In 1919 a special fund was voted to provide suitable recognition for service men, and a part of this was secured by increasing by ½ per cent the rate on interest and dividends during the years 1918-1921 inclusive.[48] At the same time the rate on business incomes received during the years 1918 and 1919 was increased by 1 per cent.[49] The war emergency was likewise made the occasion, in West Virginia, for an additional tax on corporate incomes at a rate not in excess of ¼ per cent, which was to endure until the end of the fiscal year after the termination of the war.[50] The board of public works was to determine the exact rate and the proceeds were to go into a special fund for the state council of defense. This emergency act was repealed in 1919, but the additional rate of ¼ per cent was retained and made permanent.[51]

In contrast with the progress which has been made at some points in the development of state income taxation is the diversity which marks the various statutory rules for the apportionment of income to the state, especially in the case of corporations. This problem was characterized by Professor Seligman as one of the most difficult of solution by the states,[52] while the National Tax Association Committee on a Model System of State and Local Taxation asserted that "practicable methods" existed for making such a determination and that no serious difficulty was to be apprehended at this point.[53] The latter position was properly enough taken in the case of the valuation of the railroads and other public utilities, under the unit rule of assessment and assignment of value on the mileage basis.[54] Some states, including West Virginia, Missouri, and North Dakota, have taken a similar basis

47 *Laws of Massachusetts,* 1918, ch. 252.
48 *Ibid.,* 1919, ch. 342.
49 *Ibid.,* ch. 324.
50 *Laws of West Virginia, Extraordinary Session,* 1917, ch. 6.
51 *Ibid.,* 1919, ch. 7.
52 Seligman, *The Income Tax* (1911), pp. 645-649.
53 *Preliminary Report on the Model System,* p. 29.

for the apportionment of corporate income to the state, on the assumption that the distribution of property is a satisfactory guide to the distribution of income. But is this true of the manufacturing concern doing business in several states? The raw materials are bought in one state, the processes of manufacture are carried on in another, and the products are sold in many others. In which state is the income earned, or in what manner shall it be apportioned? Any allocation of income in such a case must be arbitrary, but there may be serious and extensive multiple taxation unless there is some approach to uniformity in the methods, or at least in the results, of the apportionment. The most suggestive method which has yet appeared, in the writer's judgment, is that contained in the Massachusetts law of 1919;[55] and its value lies largely in the fact that the apportionment is to be determined by a number of factors in so far as these are severally applicable. This rule may be summarized as follows:

First, such part of the net income as would be taxable under the income tax laws of 1916, if received by an inhabitant, is made taxable. The details of this deduction are simply a coördination of this tax with the law of 1916, and are of local interest only. The amount of net income which remains after the deduction of such amounts as would be taxable under the above provision is to be divided into three parts; of these parts, one is to be apportioned to the state on the basis of the location of the tangible property within and without the state; another is to be apportioned on the basis of the wages, salaries, commissions, and other compensation paid to employees within and without the state; and the final third on the basis of the relative gross receipts. The scope of the last two bases is definitely set forth in the law. This rule appears complicated, but no simple rule can preserve the equities; and while mere complexity is no guaranty of such a result, the odds are certainly in favor of a rule, which, like that of Massachusetts, gives weight to the more important factors involved in the origin of interstate income.

Another question of some practical importance is the extent to which the returns to the federal government and the determination of net income thereunder should be made the sole basis for the state's assessment of net income. The laws of Connecticut and

[54] But *Cf.* Lutz, *The State Tax Commission,* p. 305, for the case of the express companies in Michigan.

[55] *Laws of Massachusetts,* 1919, ch. 355.

Massachusetts make the federal determination of net income final, while West Virginia, New York, and some other states, permit an independent assessment of net income by the state authorities, without precluding the acceptance of the federal assessment. It is no reflection on the accuracy of the latter to recommend that the state officials be allowed original jurisdiction. In Connecticut some difficulty has been experienced in securing a complete file of the series of amendments and corrections which have been made and allowed by the federal auditors, and the uncertainty to which such a condition naturally gives rise is very undesirable from the administrative standpoint.

A final question to be touched upon is that of the proper disposition of the receipts from the state income tax. All of the states except Wisconsin, New York, and Massachusetts retain the entire proceeds for the use of the state government. None of them is hampered as Ohio is, with a constitutional requirement that at least one half of the yield be distributed to the municipality or township of source.[56] Whether the yield is to be retained by the state or distributed locally is always a matter of purely local concern; but this much seems clear from the experience of Wisconsin, and it makes the outlook especially discouraging in Ohio, that it is unwise to undertake distribution of any large part of the tax to the district of source, assuming that the source can be unfailingly determined. Under the plan of returning 70 per cent to the districts of origin, certain rural towns in Wisconsin in which large industrial plants are located appear to be receiving an income far in excess of their requirements, a condition which is certainly not conducive to economy of public management.[57] Beyond the extent to which an equalization of revenue is required by the exemption of intangibles or other personal property, the best use of the income tax would appear to be for interests or purposes which are statewide, such as education, public health conservation, and similar activities. The example of Massachusetts, in setting aside about $4,000,000 from the proceeds of the income tax as a state school fund for the equalization of educational opportunities throughout the state, is worthy of emulation.[58]

[56] *Constitution of Ohio,* art. XII, sec. 9.

[57] Lyon, "The Distribution of Income Taxes to Localities," *Bull. Nat. Tax Assoc.,* vol. V (Dec., 1919), p. 73.

[58] *Laws of Massachusetts,* 1919, ch. 363.

III

Some brief conclusions may be drawn from this survey of the newer income tax movement.

First, the diversity and variety of legislation is unfortunate; and, if this tendency continues, diversity and variety may become chaos. If such a thing is at all feasible, a model income tax law should be drafted and recommended by the National Tax Association or some other body.

Second, there has been marked progress in the formulation of certain features of income taxation, such as the definition of income, the relation of income and property taxes, and at other points. With all of the agencies which are capable of influencing legislative action in coöperation behind a program, the unwise tendencies toward diversity might be checked.

Third, a number of states appear to have been attracted to the income tax with little regard to the proper conditions upon which success depends. Effective administration is certainly the most important single condition to be emphasized, without which the income tax has never succeeded.

Fourth, under the kind of administration that is now possible, the system of assessment upon original return is superior to that of stoppage at the source. Information at the source is a very useful aid to administration and should be extensively employed.

Fifth, under the proper conditions of income capacity and administrative efficiency, there is no doubt of the fiscal adequacy and elasticity of the income tax. The fiscal results will be relatively much more important in the states with a large urban population and with the higher range of incomes which this concentration of population and wealth betokens.

Sixth, the income tax is not necessarily the road to financial salvation for every state. This is not the first time that the states have hastened to patronize a new and attractive fiscal panacea, nor will it be the last. Each local revenue system must be adapted to reach the local sources of taxpaying capacity, and it remains to be seen to what extent the income tax is a useful tax form for reaching this capacity under all circumstances and in all parts of the country. Careful study of local conditions should precede the introduction not only of this, but of every other experiment in financial legislation.

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